

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
MONTGOMERY, ALABAMA

REPORT OF LIMITED SCOPE EXAMINATION OF
AMERICAN RESOURCES INSURANCE COMPANY

MOBILE, ALABAMA

AS OF JUNE 30, 2006

PARTICIPATION:
SOUTHEASTERN ZONE, NAIC
ALABAMA

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STATE OF ALABAMA
COUNTY OF MOBILE

I, Palmer W. Nelson, being first duly sworn, upon his oath deposes and says:

That he is an examiner appointed by the Commissioner of Insurance for the State of Alabama;


That an examination was made of the affairs and financial condition of American Resources Insurance Company as of June 30, 2006;

That the following 39 pages constitute the report thereon to the Commissioner of Insurance of the State of Alabama;

And that the statements, exhibits and data therein contained are true and correct to the best of his knowledge and belief.


Palmer W. Nelson, CFE

Subscribed and sworn to before the undersigned authority this 17th day of November, 2006.


(Signature of Notary)

SHARROW BAKER, Notary Public
(Print Name)

in and for the State of Alabama.

My commission expires 6-20-07.



BOB RILEY
GOVERNOR

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Mobile, Alabama
November 17, 2006

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Dear Commissioners,

Pursuant to your instructions and in compliance with the statutory requirements of the State of Alabama and the resolutions adopted by the National Association of Insurance Commissioners, a limited scope examination has been made of the affairs and condition of

American Resources Insurance Company
Mobile, Alabama

as of June 30, 2006, at its home office located at 1111 Hillcrest Road, Mobile, Alabama 36695. The report of examination appears herewith.

Where the term "Company" or "ARIC" appears herein without qualification, it will be understood to indicate American Resources Insurance Company.

SCOPE OF EXAMINATION

The Company was last examined for the five year period ending December 31, 2003, by examiners representing the Alabama Department of Insurance. The examination was a full scope financial and market conduct examination. The current limited scope examination was conducted as of June 30, 2006, and was conducted by Alabama Department of Insurance examiners. When deemed appropriate, transactions subsequent to June 30, 2006 were reviewed. The examination was made in accordance with the statutory requirements of the Alabama Insurance Code and the Alabama Insurance Department's regulations and bulletins; in accordance with the applicable guidelines and procedures promulgated by the NAIC; and in accordance with generally accepted examination standards and practices in connection with the verification of assets and determination of liabilities.

The President and Secretary/Treasurer of the Company, Lamar Lee and Stephen Pate, requested a meeting with Alabama Department of Insurance officials to disclose problems that the Company had experienced with respect to the Company's automobile warranty business and the fact that some of the trust account funds associated with the automobile warranty business were missing. The meeting was held on May 24, 2006, in which management reported the issues to the Alabama Department of Insurance. A second meeting of Mr. Lee and Mr. Pate and the Alabama Department of Insurance officials was held on June 28, 2006. The automobile warranty business, missing trust funds, and the ownership of the Company were discussed. A third meeting of Company management and Department officials occurred on July 10, 2006. Attending on behalf of the Company were Lamar Lee, Stephen Pate, Anthony Marino, and James Perry Bryan. The automobile warranty business, missing trust funds, and the ownership of the Company were discussed.

The current examination was a limited scope examination. The examiners' scope was limited to the following objectives:

- (1) Determine the owners of the Company; Determine the Company's ultimate controlling person;
- (2) Determine what the Company's reinsurance program covers for its automobile warranty business;
- (3) Determine the Company's liabilities with respect to the Company's automobile warranty business;
- (4) Determine if all of the funds that are required to be deposited or invested in the automobile warranty trust accounts have been

properly deposited or invested; If the assets were misappropriated, determine how so, and determine the whereabouts of the misappropriated assets if possible; Identify potential fraudulent activities that may have occurred.

The examiners were given authority to examine any other issues that the examiners deemed to require an examination.

A signed certificate of representation was obtained during the course of the examination. In this certificate, management attests to have valid title to all assets and to the nonexistence of unrecorded liabilities as of June 30, 2006. A signed letter of representation was also obtained at the conclusion of the examination whereby management represented that, through November 16, 2006, complete disclosure was made to the examiners regarding asset and liability valuation, financial position of the Company, and contingent liabilities.

ORGANIZATION AND HISTORY

The Company was incorporated in Mobile County, under the laws of the State of Alabama on January 27, 1981, as a wholly owned subsidiary of ARIC Investments, Inc., an Alabama corporation.

According to Article II of the Articles of Incorporation, the primary purpose of the incorporation, in addition to the authority conferred upon corporations formed under the Alabama Business Corporation Act, is to issue policies and enter into contracts of property insurance, casualty insurance, as well as other casualty or insurance risks which lawfully may be made the subject of insurance.

Article IV of the original charter provided for authorized capital of \$1,000,000 comprised of 1,000,000 shares of \$1 par value per share common stock. In 1992, the Company's charter was amended to increase the total authorized capital to \$5,000,000 comprised of 5,000,000 shares of \$1 par value per share common stock.

The Company's capital structure as of December 31, 2003, the date of the most recent full scope examination conducted by the Alabama Department of Insurance examiners, consisted of 5,000,000 authorized shares of common stock with a par value of \$1 per share, with 1,500,000 shares issued and outstanding for total capital of \$1,500,000, and \$1,500,000 in gross paid in and contributed surplus. On December 31, 2003, the Company had unassigned

funds of \$5,911,223 and a total capital and surplus of \$8,911,223 per the examination report.

The Company issued a surplus note in the amount of \$3,000,000 during 2004. During 2005, the Company received a surplus contribution of \$3,600,000.

At June 30, 2006, the Company's capital structure consisted of 5,000,000 authorized shares of common stock with a par value of \$1 per share, with 1,500,000 shares issued and outstanding for total capital of \$1,500,000; \$5,100,000 in gross paid in and contributed surplus; a surplus note for \$3,000,000; and, unassigned funds of \$4,673,669. The Company's total capital and surplus as of June 30, 2006, was \$14,273,669 per the examination.

The \$3,000,000 surplus note was issued by the Company to Dekania CDO II, Ltd. and was approved by the Alabama Department of Insurance Commissioner on May 17, 2004. Interest accrues on the principal balance of the note at the LIBOR rate plus 4.10%. The terms of the note require that the interest and principal payments on the note to be paid out of the Company's surplus exceeding \$11,290,140.

As of the date of the most recent full scope examination, the Company's sole shareholder, ARIC Investments, Inc., was owned by seven individuals and one corporation. The Company's sole shareholder was acquired by new owners on September 2, 2005. A new holding company, AR Holding, Inc., was formed in association with the acquisition. Following the acquisition, ARIC Investments, remained as the sole owner of the Company. ARIC Investments was wholly owned by AR Holding, an Alabama corporation. AR Holding was wholly owned by HAIG, LP, a Cayman Islands corporation.

The Company reported in its June 30, 2006 Quarterly Statement that the ownership of the Company's sole shareholder, ARIC Investments, changed significantly from the prior quarterly reporting. The Company reported that the ownership of ARIC Investments changed from 100% ownership by AR Holding to the following owners and percentages of ownership:

<u>Owner</u>	<u>Percentage of Ownership</u>
AR Holding, Inc.	42.18%
AlaComp	24.14%
Ultimate Reserve Trust	17.44%
Marathon Financial Insurance Company	8.12%
James P. Bryan, IRA	8.12%

The owners and percentages of ownership of ARIC Investments, Inc. identified above were reported by the Company. Determining the owners of the Company and the ultimate controlling person was one of the objectives of the limited scope examination. Further discussion of the ownership of the Company and the examination of the owners and ultimate controlling person of the Company is included in this report under the caption "EXAMINATION FINDINGS - Determine the Owners of the Company; Determine the Company's Ultimate Controlling Person."

MANAGEMENT AND CONTROL

Stockholders

The Company is a stock corporation. At June 30, 2006, one hundred percent of the Company's issued and outstanding stock was owned by ARIC Investments, Inc.

Board of Directors

Following the September 2, 2005 acquisition, the Company had four directors. The four directors were James Edwin Tait, Lee Crawford Summers, Stephen Ralph Windom and Harvey Lamar Lee. On June 30, 2006, directors Tait, Summers, and Windom resigned. The directors as of June 30, 2006, subsequent to the resignations effective that day, were:

James Perry Bryan
Harvey Lamar Lee
Anthony Phillip Marino

Officers

The officers of the Company at June 30, 2006, were:

<u>Officer</u>	<u>Title</u>
Harvey Lamar Lee, President	President
Stephen Gregory Pate	Secretary & Treasurer
Michael Reeves Brady	Vice President, Underwriting
Nina Simons O'Hara	Vice President, Finance
*Louis Eugene Tariffa	Vice President, Claims

*The officer has resigned subsequent to June 30, 2006.

Conflicts of Interest

The Company's conflict of interest policy and 2006 conflict of interest statements filed by its officers, directors, and management employees were reviewed.

The Company's conflict of interest policy requires the Company's officers, directors, and management employees to report potential conflicts of interest. All of the officers and directors as of December 31, 2005 signed and completed a questionnaire with one exception. Director Steve Windom did not complete a questionnaire. However, he resigned as a director of the Company on June 30, 2006.

The examination indicated that a director of the Company, James Perry Bryan, was in a position that resulted in a pecuniary interest violation. Mr. Bryan had the following ownership interests as well as serving as a director of the Company. The Company reported in its June 30, 2006 Quarterly Statement that Mr. Bryan's IRA owns 8.12% of ARIC Investments, Inc., the Company's sole shareholder. Mr. Bryan owns a 36.5% ownership interest in Marathon Financial Insurance Company. Marathon Financial Insurance Company is reported to have an 8.12% ownership interest in ARIC Investments, Inc. as of June 30, 2006. Mr. Bryan owns a 36.5% ownership interest in Marathon Administrative Company. The Company has entered into a material business venture with both of the aforesaid Marathon entities. Marathon Administrative Company is the Company's insured under a material contractual liability insurance policy (CLIP). All of the business under the aforesaid CLIP is reinsured on a 100% quota share basis to Marathon Financial Insurance Company. The Company is not in compliance with ALA CODE §27-27-26(a) which states, in part,

Any officer, or director, or any member of any committee or any employee of a domestic insurer who is charged with the duty of investing or handling the insurer's funds... shall not be pecuniarily interested in any loan, pledge or deposit, security, investment, sale, purchase, exchange, reinsurance, or other similar transaction or property of such insurer except as a stockholder or member...

TERRITORY AND PLAN OF OPERATION

At the examination date, the Company was licensed to transact business in the following eight states:

Alabama	Indiana	Mississippi	Tennessee
Georgia	Kentucky	South Carolina	Virginia

According to the Company's 2005 Annual Statement, the Company's most significant lines of business in regards to net premiums written were commercial multiple peril, workers' compensation, and commercial auto liability. These three lines of business accounted for over 82% of the Company's 2005 net written premiums. The percentages of each of the lines of business of the 2005 total net written premiums were:

<u>Line of Business</u>	<u>Percentage of the Total 2005 Net Premiums</u>
Commercial Multi-Peril	45.1%
Workers' Compensation	19.1%
Commercial Auto Liability	18.6%

The Company's contractual liability policies involving automobile service warranty contracts were the focus of this examination. The Company reported \$412,051 direct written premiums for the contractual liability for automobile warranties line of business for the year to date in its June 30, 2006 Quarterly Statement. The amount was 5% of the Company's direct premiums written for the year to date. However, the examiners could not perform test work to verify the reported amount. Further discussion of the premiums accuracy and completeness test work that could not be performed by the examiners is included in this report under the caption "ACCOUNTS AND RECORDS."

The Company did not write any automobile service warranty contracts. The Company issued contractual liability insurance policies to the entities that issued automobile service warranty contracts.

CORPORATE RECORDS

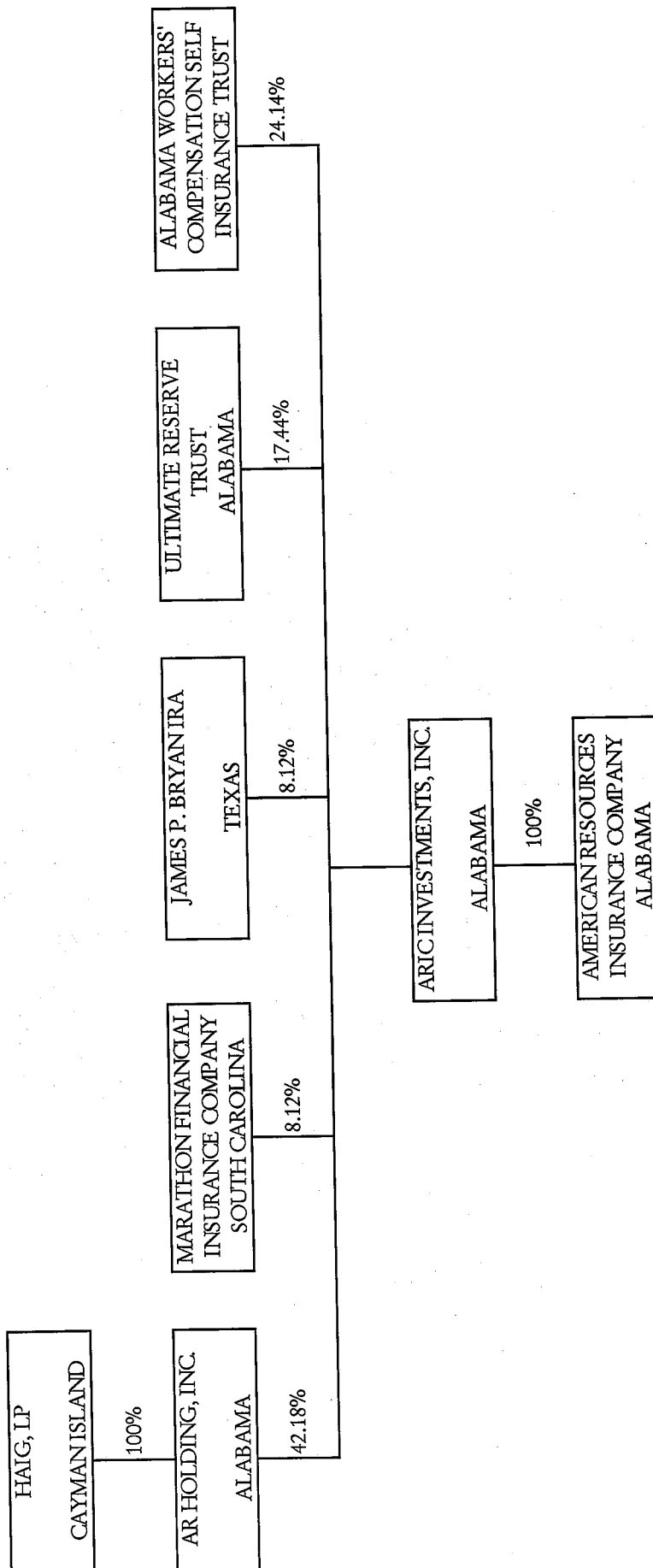
During the course of the examination, Company personnel indicated that some of the holding company filings and the Company's stock records were obtained from its former director, Lee Summers, in Boca Raton, Florida. Former director, James Tait, kept reinsurance agreements away from the home office.

During the examination, Company personnel provided examiners evidence of a court filing requesting the Company's records from the two aforesaid individuals. ALA CODE §27-27-29(a) states "Every domestic insurer shall have, and maintain, its principal place of business and home office in this state and shall keep therein, complete records of its assets, transactions and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted."

ORGANIZATIONAL CHART

The chart on the following page depicts the insurance holding company system with which the Company was affiliated as of June 30, 2006, based on representations made by Company management.

AMERICAN RESOURCES INSURANCE COMPANY
ORGANIZATIONAL CHART*
AS OF JUNE 30, 2006



*The organizational chart is prepared on the basis of representations made by Company management and the review of the Company's filed financial statements. The examiners could not verify the owners of ARIC Investments, Inc. from the review of the ARIC Investments, Inc. stock ledger.

FIDELITY BOND

At June 30, 2006, the Company was a named insured under a crime coverage policy, issued by Cincinnati Insurance Company, Cincinnati, Ohio. The loss limit liability for dishonesty was \$1,000,000 with a loss liability deductible of \$1,000; while the loss limit liability for forgery or alteration was \$125,000 with a loss limit deductible of \$1,000, which exceeded the minimum requirements for fidelity coverage, as defined by NAIC guidelines.

The Company disclosed that a former director of the Company allegedly committed some fraudulent acts. As mentioned previously, the Company's crime policy affords dishonesty coverage for employees. However, the director was not an employee per se. In referring to the Crime Policy, the definition of "employee" is found indicating that a *director* is not considered to be an employee as the policy states an employee is "any natural person... Whom you compensate directly by salary, wages or commissions." The crime policy further states that, "employee dishonesty means only dishonest acts committed by an employee."

However, Company management has informed the examiners that the Company does in fact intend to file a claim on its crime policy with Cincinnati Insurance. Currently, the Company is in the process of completing its claim to be filed.

During the period under examination, the Company purchased Directors and Officers liability coverage through Houston Casualty Company, Houston, Texas, which became effective March 9, 2006. As previously mentioned, the examination revealed that a former director of the Company is suspected of alleged fraudulent activities which occurred during the time period he was serving in the capacity as a director of the Company.

STATUTORY DEPOSITS

The reported statutory deposits were verified by the examiners. In order to comply with the statutory requirements for doing business in the various jurisdictions in which it was licensed, the Company had the following securities on deposit with state authorities at June 30, 2006.

<u>State</u>	<u>Par Value</u>	<u>Statement Value</u>	<u>Market Value</u>
Alabama	\$1,005,000	\$1,004,309	\$960,510
Georgia	100,000	100,000	98,313
South Carolina	250,000	250,000	246,250
Virginia	250,000	250,000	234,452

FINANCIAL CONDITION/GROWTH OF THE COMPANY

The following table sets forth the significant items indicating growth and financial condition of the Company.

	6/30/2006	12/31/2005	12/31/2004
Admitted Assets	\$59,457,521	\$57,482,372	\$49,442,006
Liabilities	45,183,852	39,631,846	35,793,907
Common Capital Stock	1,500,000	1,500,000	1,500,000
Paid in and Contributed Surplus	5,100,000	5,100,000	1,500,000
Surplus Notes	3,000,000	3,000,000	3,000,000
Unassigned Funds	4,673,669	8,250,526	7,648,099
Net Written Premiums	10,734,795	19,738,595	20,447,409

REINSURANCE

The examiners' review of the reinsurance accounts and transactions was limited to the review of the reinsurance agreements associated with the Company's automobile warranty business.

The Company provided the examiners the reinsurance agreements evidencing the reinsurance for the Ultimate Warranty and Marathon Administrative contractual liability insurance policies (CLIPs). The Ultimate Warranty CLIP was reinsured by Capital Assurance Risk Retention Group, Inc. and the Marathon Administrative CLIP was reinsured by the Marathon Financial Insurance Company, Inc. Both reinsurance agreements involved 100% quota share reinsurance. Company management indicated that the premiums due the Company under the CLIPs were paid directly to the respective reinsurers by the Company's insureds. The review of the reinsurance agreements for the Ultimate Warranty and Marathon CLIPs indicated that the Company was required by both of the respective agreements to remit the pro rata share of premiums to the reinsurer. The agreements both state "Within 20 days after the close of each month, the Company will furnish the Reinsurer with a report

summarizing the gross premium, premium ceded less return premium and commission, losses paid, loss expenses paid, monies recovered, and net balance due each party. The net balance will be paid within 25 days after the close of the respective month." The Company has not been remitting its premiums in accordance with its reinsurance agreements. Company management indicated that the program administration and insurance agreements allowed the administrators to pay the premiums to the reinsurer. The Company will be required to amend its program administration and insurance agreements in order to comply with the provisions of the reinsurance agreements. The Ultimate Warranty CLIP has subsequently been cancelled and is in the claims run off stage.

The Company did not subject the auto warranty reinsurance contracts to a minimum standards review. The Company's Chairman of the Board, James Tait, had the exclusive authority to independently negotiate, execute, and retain the reinsurance agreements. After the Chairman resigned, Company personnel were unable to find and provide to the examiners the reinsurance agreements for the Warrantech Automotive and Butler Financial CLIPs. The examiners could not verify the existence of the reinsurance for the said CLIPs. Company management maintained that the missing agreements were 100% quota share reinsurance agreements with Capital Assurance Risk Retention Group covering the aforesaid CLIPs.

Capital Assurance Risk Retention Group and Marathon Financial Insurance Company were the reinsuring entities that assumed the Company's liabilities in association with its auto warranty contractual liability insurance policies. The reinsurers were not reinsurers of a medium to large capitalization size. The entities had total assets of \$6 million and \$10.6 million, respectively at December 31, 2005. The treaties transfer a substantial amount of risk (100% quota share). It is not apparent that the reinsuring entities have a capitalization large enough to accept the significant amount of risk involved.

The Company's reinsurance agreement with Marathon Financial Insurance Company, Inc. did not indicate the effective date of coverage or the date in which the agreement could be cancelled. The agreement included date blanks for these stipulations, but the date fields were left blank in the signed agreements.

The Company recorded reserve credits as if its Warrantech Automotive CLIP and its Butler Financial CLIP were reinsured on a 100% quota share basis. The Company was unable to provide the examiners evidence of the existence of the

reinsurance. The reinsurance agreements and evidence of the payment of the reinsurer's quota share proportion of the premium were requested, but were not received. Further discussion of the unverified reinsurance for the aforesaid CLIPs is included in this report under the Caption "NOTES TO FINANCIAL STATEMENTS - Note 1."

ACCOUNTS AND RECORDS

The examiners review of the Company's accounting records indicated the following noteworthy issues.

Premiums for Contractual Liability Insurance Policies for Automobile Service Warranty Contracts

The examination noted that the Company was recording its insured's reporting of the number of covered contracts and had not performed any audits of the information provided. The Company has the right to verify the information by a physical audit of the information as provided for in the program and administration agreements, but no formal audits have been performed. Summary reports were prepared by the insured entities issuing auto warranty service contracts and the financial results were recorded by the Company based on the representations of the Company's insureds. ALA CODE §27-27-29(a)(1975) states, in part, "Every domestic insurer shall have, and maintain... complete records of its assets, transactions and affairs..."

The Company did not collect its premiums due for the auto warranty business, but allowed the insured to remit the premiums directly to the Company's reinsurer. Further discussion of the flow of premiums from the Company's insured to the Company's reinsurer is included in this report under the caption "REINSURANCE." Upon request by the examiners, the Company provided detailed data but did not provide the underlying source documentation for its auto warranty business premiums or auto warranty business unearned premiums. Due to the lack of supporting documentation, the examiners could not perform accuracy and completeness testing for the auto warranty business premiums and unearned premiums.

Loss Reserves for Contractual Liability Insurance Policies for Automobile Service Warranty Contracts

The vehicle service contracts paid claims were not tested for accuracy and completeness. The examiners noted that the Company had the right to audit

the paid vehicle service contract transactions at its insured's office, but had not conducted any audits. The examination noted that the vehicle service contract transactions data was recorded without any auditing or testing of the data. The financial results produced by the data were recorded and the data was not subjected to any verification. The underlying source documents were not available to the examiners.

Loans/Advances to AR Holding, Inc. and ARIC Investments, Inc.

During the review of the detail related to the AR Holding, Inc. checking account which was maintained at the Town and Country Bank, Camden, Alabama, it was noted that AR Holding received a \$100,000 deposit on September 19, 2005. This particular advance was requested by Jim Tait, a former director of the Company, and was funded entirely via a check drawn on American Resources Insurance Company, Inc. which was signed by Diane Green and the President of the Company, Mr. Lamar Lee. The purpose of the loan was to pay holding company expenses. Even though this \$100,000 loan was subsequently paid from proceeds of a Senior Note, the fact remains that an advance was made to the Company's parent. AR Holding, Inc. is a parent and stockholder of the Company, and as such, an advance to a controlling stockholder is not in accordance with ALA. CODE §27-41-36(a) which states, "After January 1, 1978, an insurer shall not invest nor lend its funds upon the security of any note or other evidence of indebtedness of any director, officer or controlling stockholder of the insurer, except as to policy loans authorized under §27-41-25 and except as provided in §27-1-2, §27-27-26 and §27-37-2 of the Alabama Insurance Code."

During the review of the Company's accounts payable, it was noted that the Company had paid \$10,307 in payables that belonged to its parent, ARIC Investments, Inc. The supporting vouchers for these disbursements indicated that the Company had paid legal expenses that belonged to its parent. ALA CODE §27-41-36 (a) states "After January 1, 1978, an insurer shall not invest nor lend its funds upon the security of any note or other evidence of indebtedness of any director, officer or controlling stockholder of the insurer, except as to policy loans authorized under §27-41-25 and except as provided in §27-1-2, §27-27-26, and §27-37-2 of the Alabama Insurance Code."

Company Expenditures

In the review of the detail supporting the accounts payables, it was noted that the Company was paying for and expensing airline tickets for the wife of the

Company's President, Lamar Lee. The amounts for these airline tickets totaled to \$2,924.00 from 2004 through 2006. It was noted that the Company had not properly reported to the IRS approximately \$1,000 which related to tickets purchased during 2005. This issue was brought to the attention of the Company and Lamar Lee stated that the Company would issue a W-2 for these amounts in January, 2007.

Review of Unusual Disbursements from Town and Country Bank Accounts, Camden, Alabama

At the onset of the examination, the Company was associated with two premium trust accounts which were housed at the Town and Country Bank Camden, Alabama. These two premium trust accounts were the Ultimate Warranty Trust Account and the Warrantech Trust Account. James Tait, a former director of the Company was listed as a trustee and a signor on these accounts. Cancelled checks from the Ultimate Warranty trust account indicate that Mr. Tait had written numerous checks from these accounts that were highly questionable in nature. Examples of this are a check for \$250,000 that was written to James Tait's brother, Albert Tait; checks totaling \$1,047,791 were written to Don McCloud trust which Company management purports was used to purchase real property in which the Ultimate Reserve Trust was not indicated on the deed; checks totaling \$110,000 were written to Tait Advisory Services; and James Tait wrote checks payable to himself totaling \$20,000.

Further, two more accounts were maintained at the Town and Country Bank, Camden, Alabama. These two accounts were the AR Holding and the ARIC Investment accounts in which James Tait was also listed as a signor. Lee Summers, a former director of the Company, received checks totaling \$57,500 from the AR Holding account and checks totaling \$60,000 from the ARIC Investment account. James Tait wrote himself checks totaling \$118,463 from the AR Holding Account and checks totaling \$86,468 from the ARIC Investment account.

To date, Company management advises that they had no control over AR Holding's account and they can not provide vouchers or supportive documentation for these checks and Mr. Tait would not provide these when requested.

Company management alleges that James Tait committed fraud and he resigned as a Director of the Company and amendments to the trust

agreements removed Tait as a Trustee of the auto warranty business trust accounts. These same amendments to the trust accounts added Stephen Pate, Secretary and Treasurer of the Company, as a Trustee on the trust accounts. Also, Pate was listed as a signor on the aforementioned accounts. The accounts were transferred to Wachovia Bank in Mobile, Alabama and are now drawing interest for the benefit of the Company.

A. M. Best Rating

The Company's A.M. Best rating declined from an "A-" to a "B" during 2006. During the course of the examination the examiners received a request from the Company President inquiring about a manner in which to expedite the licensing of an insurer in Alabama. Discussions indicated that the Company is considering entering into a fronting arrangement with an "A" rated insurer to market its business. The Company writes primarily commercial lines of business. The examiners entered into discussions with the Company President about the Company's business plan, particularly in light of the recent down grade.

The Company President indicated that the Company's primary goal is to regain the "A-" rating from A. M. Best. The Company President indicated the following when questioned about the potential impact of the down grade. Due to the rating change, management projects that its premium growth will not continue. Certain accounts written by the Company have contractual requirements specifying that the insurers must be rated higher than a "B." In consideration of the contractual requirements, a portion of the Company's current book of business will not renew and a decline in new business is projected as well. Company management indicated that the Company had 2006 year to date written premiums at June 30, 2006, of \$15,462,048 and the third and fourth quarter projected written premiums are \$12 million. Written premium projections for the first and second quarters of 2007 are \$12.5 million. Management anticipates that premium growth will resume after a full twelve month cycle following the down grade. Management expects to accomplish its goals and resume premium growth by concentrating its marketing efforts on the smaller accounts. As for possible solutions to marketing to entities requiring an "A" rated insurer that the Company is considering, the Company is in negotiations with a carrier to have an option to offer alternative coverage through an "A" rated carrier utilizing a managing general agent arrangement. The alternative would be available on a select basis to those accounts with contractual requirements for an "A" rated carrier. The Company may share in this risk through participation in a quota share

reinsurance contract. Also, the President indicated that the Company has entered into discussions with three entities as possible investment partners.

EXAMINATION FINDINGS

Determine the owners of the Company; Determine the Company's ultimate controlling person

There appears to be a question regarding ownership and control of ARIC Investments, Inc. which may require further resolution. The Company was acquired on September 2, 2005. The acquisition involved forming a new holding company, AR Holding, Inc. which is wholly owned by HAIG, LP (Cayman Islands). Company management filed its June 30, 2006 financial statements indicating that the ownership had changed once again. No formal holding company filings or Departmental hearings or approvals have occurred. The Company Secretary and Treasurer, Stephen Pate, indicated that the change came from a "deemed conversion" of convertible preferred stock issued by ARIC Investment, Inc., the Company's sole shareholder. Subsequent correspondence provided by the Alabama Department of Insurance detailing conversations with Steve Windom, former director and counsel representing the Company in regulatory matters, indicated that it was a conversion and not a deemed conversion, but the stock certificates had not been issued yet. The examiners' review of the ARIC Investments, Inc. stock ledger on October 31, 2006 indicated that the ARIC Investments, Inc. had 1,000 shares of voting common stock issued. All of the shares were issued to AR Holding, Inc. The chronological order of events that resulted in the September 2, 2005 and subsequent 2006 change in ownerships is as follows.

There was a scheduled Form A hearing in 2005 in which an acquisition did not occur. An amended Form A was filed following the failed acquisition. Management's representations and correspondence files reviewed by the examiners indicate that the failed acquisition occurred because the required funds were not available to consummate the acquisition. After amending the Form A filing, an acquisition was approved that was consummated. The original order approved the acquisition on March 2, 2005. The subsequent amendment was approved subject to the receipt of necessary funds. The acquisition occurred on September 2, 2005. Following the acquisition the Company's sole shareholder, ARIC Investments, became wholly owned by AR Holding, Inc. AR Holding, Inc. is wholly owned by HAIG, LP (Cayman Islands).

The acquisition was ultimately made with funds provided by HAIG, LP and funds borrowed by AR Holding, Inc. AR Holding's notes that were used to finance the acquisition became due. The Ultimate Reserve Trust (reserve trust account for the Ultimate Warranty contractual liability insurance policy) paid three of the five short term notes used to finance the acquisition.

Ultimate Warranty Trust, J. P. Bryan, Marathon Financial Insurance Company, and Alabama Workers' Compensation Self Insurance Trust, Alabama received convertible preferred stock in ARIC Investments. The convertible preferred stock was convertible into voting common stock of ARIC Investments under specific conditions. Management of the Company maintained that a deemed conversion had occurred. The ownership percentages of the ARIC Investments, Inc. which is the sole owner of the Company based on the deemed conversion is: AR Holding, Inc. - 42.18%, Alabama Workers' Compensation Self Insurance Trust - 24.14%, Ultimate Warranty Trust - 17.44%, Marathon Financial Insurance Company - 8.12%, and James P. Bryan, IRA - 8.12%. An illustration of the reported ownership of the Company is included in this report under the caption "ORGANIZATIONAL CHART."

The Company indicated in its June 30, 2006 Quarterly Statement that Ultimate Reserve Trust account owned 17.44% of ARIC Investments, Inc., the Company's sole shareholder. The aforesaid trust account is an account established for the benefit of the Company to receive reserve funds associated with vehicle service contracts (VSCs) insured by the Ultimate Warranty contractual liability insurance policy. These funds constitute reserves that have been established to pay anticipated claims related to the VSCs issued by Ultimate Warranty Corporation. The Ultimate Warranty Trust Agreement provided broad investment authority to the three trustees. The examiners noted the unusual investment in ARIC Investments. In the event that the investment must be liquidated to pay claims, shares of the Company's sole shareholder, which is not a publicly traded company, will have to be sold to pay the VSCs' claims.

The Company's filed financial statements indicate that HAIG, LP, through its 100% ownership of AR Holding, Inc., now owns a 42.18% ownership interest in the Company's sole shareholder. However, Company management has indicated that they believe that the remaining four owners of the Company's sole shareholder will act in unison, thereby controlling the Company. The examiners were unable to determine with certainty the ultimate controlling person of the Company.

Subsequent to reviewing a copy of a draft of this report, Company management represented that stock certificates of ARIC Investments, Inc. were issued to the four individuals and entities that Company management had indicated to have converted their convertible preferred shares by way of a deemed conversion. Further discussion of the issue is included in this report under the caption "SUBSEQUENT EVENTS."

Determine what the Company's reinsurance program covers for its automobile warranty business

The examination verified the existence of 100% quota share reinsurance for the Ultimate Warranty and Marathon Administrative contractual liability insurance policies (CLIPs). The Company did not provide the examiners any evidence of the reinsurance agreements or reinsurance transactions covering the Warrantech Automotive or Butler Financial CLIPs. The Company took reserve credits for the Warrantech Automotive and Butler Financial CLIPs as if the CLIPs were reinsured under a 100% quota share reinsurance agreement. An adjustment was made to the financial statements included in this report because the reinsurance could not be verified. Further discussion of the examination of the automobile warranty business reinsurance program is included in this report under the caption "REINSURANCE."

Determine the Company's liabilities with respect to the Company's automobile warranty business

The vehicle service contracts paid claims were not tested for accuracy and completeness. The Company recorded the financial results produced by the data that was provided by its insured and the data was not subjected to any audit or verification process. The underlying source documents of the nonaffiliated entities were not available to the examiners. Further discussion of the acceptance of unverified vehicle service contracts paid claims is included in this report under the caption "ACCOUNTS AND RECORDS."

The Company reported its loss reserves and reserve credits as if it had 100% quota share reinsurance for the Warrantech Automotive and Butler Financial contractual liability insurance policies (CLIPs), but the examiners could not verify that the reinsurance coverage existed. Further discussion of this issue is included in this report in the discussion of the examination objective immediately above and under the captions "REINSURANCE" and "NOTES TO FINANCIAL STATEMENTS - Note 1."

The Company disclosed the following in its June 30, 2006 Notes to Financial Statements in relation to the determination of the liabilities for its Warrantech book of business. "The determination excludes 3,196 contracts submitted for coverage but denied by ARIC as the contracts were written prior to the policy inception date covering said contracts or ARIC was not licensed and authorized to do business in the states in which the contracts were issued." Discussion with Company managers indicated that most of the contracts in question were written in states in which the Company was not licensed. The Company did not record reserves for claims associated with these policies. Further discussion of the failure to record loss or unearned premium reserves for the aforesaid policies is included in this report under the captions "NOTES TO FINANCIAL STATEMENTS - Note 1" and "COMMITMENTS AND CONTINGENT LIABILITIES."

Adjustments to the loss and unearned premium reserves were made as a result of the actuarial review. The details of the changes made are included in this report under the caption "NOTES TO FINANCIAL STATEMENTS - Note 1."

Determine if all of the funds that are required to be deposited or invested in the automobile warranty trust accounts have been properly deposited or invested; If the assets were misappropriated, determine how so, and determine the whereabouts of the misappropriated assets if possible; Identify potential fraudulent activities that may have occurred.

The Company's trust account deposits were confirmed during the examination. During the course of the examination the Company took action to move the trust deposits from a bank in Wilcox County to a bank in Mobile County and amend the trust agreements removing James Tait and Susan Marino as a trustee.

Funds from the warranty business trust accounts were allegedly misappropriated. The Company has filed a civil action against its former directors, James Tait and Lee Summers. Company management indicated that James Tait has acknowledged that he desires to pay the Ultimate Trust account back for \$1,297,791. Unexecuted copies of promissory notes were provided to the examiners. Management indicated that the unexecuted documents supported the offer received by the Company. The aforesaid amount is comprised of the following two disbursements made from the Ultimate Warranty Trust account: \$1,047,791 to Don McLeod trust allegedly for a land purchase and \$250,000 payable to Albert Tait, Jim Tait's brother. In addition

and not related to those disbursements, \$2,212,166.55 was used to pay off notes plus interest that became due in association with the 2005 acquisition. The three disbursements comprising the \$2,212,166.55 were \$479,166.65 paid to First Clearing Corporation, \$476,666.65 paid to Margo Stout, and \$1,256,333.25 paid to Stites Harbison law firm. The acquiring entity borrowed money with restrictive debt covenants. If the covenants were violated, the notes became due. The notes became due and three were paid by the Ultimate Warranty Trust account. Ultimate Warranty Trust, Alabama Workers' Compensation Self Insurance Trust, James P. Bryan, IRA, and Marathon Financial Insurance Company were issued convertible preferred stock for the payment of the notes. Company management indicated that there was a deemed conversion of the preferred stock. Following the deemed conversion, the Ultimate Warranty trust account owned 17.44% of the ownership interest of ARIC Investments, Inc., the Company's sole shareholder. The alleged new ownership interests were reported in the Company's June 30, 2006 quarterly filing.

The Company reported a liability for a "contingent liability" in its June 30, 2006 Quarterly Statement. Company management stated the following in its Notes to Financial Statements concerning the liability recorded.

The Company has booked a contingent liability of \$1,934,303.79 as of June 30, 2006. On or about May 23, 2006, the Company received information that funds were being expended from a warranty trust account by our then Chairman of the Board, James E. Tait. We are not sure of the legal ramifications of these actions but American Resources Insurance Company (Company) may be liable for the funds expended. For \$1,734,303.79 that was expended, the Company was unable to determine a value for the possible assets received by the Trust and the Company has therefore booked a loss for this amount in operations. \$2,212,166.55 of the funds expended was used to purchase notes issued by AR Holding which were then purchased through the issuance of 2,232,420 shares of preferred stock in ARIC Investment, Inc., the parent Company of American Resources Insurance Company. This gives the trust a 17.44% interest in ARIC Investments, Inc. Due to the above loss contingency being recorded, the stock of ARIC Investments, Inc. has decreased in value. The estimate of the decrease in value for the trust's percentage is approximately \$200,000 and has also been booked as a loss.

FINANCIAL STATEMENTS

The financial statements included in this report were prepared on the basis of the Company's records, and the valuations and determinations were made during the examination as of June 30, 2006. Amounts shown in the comparative statements for the periods ended at year-ends 2004 and 2005 were compiled from the Company's copies of filed Annual Statements. The statements were presented in the following order:

Statement of Assets, Liabilities, Surplus and Other Funds	Page 24
Summary of Operations	Page 25
Capital and Surplus Account	Page 26

American Resources Insurance Company
Statement of Assets, Liabilities, Surplus and Other Funds
For the Quarter Ended June 30, 2006

Assets

	<u>Ledger Assets</u>	<u>Non- admitted Assets</u>	<u>Admitted Assets</u>
Bonds	\$34,987,589		\$34,987,589
Real Estate: Properties occupied by the Company	1,446,720		1,446,720
Cash and short-term investments	11,903,449		11,903,449
Investment income due and accrued	345,885		345,885
Uncollected premiums and agents balances in the course of collection	2,559,972	\$(90,427)	2,469,545
Deferred premiums, agents' balances and installments booked but deferred and not yet due	5,653,998		5,653,998
Amounts recoverable from reinsurers	421,640		421,640
Net deferred tax asset	2,386,575	(332,736)	2,053,839
Electronic data processing equipment and software	33,959		33,959
Furniture and equipment	109,431	(109,431)	
Receivables from parent, subsidiaries and affiliates	111,108	(111,108)	
Anticipated income from trust accounts (Note 1)	1,147,619	(1,147,619)	
Aggregate write-ins for other than invested assets	241,296	(100,400)	140,896
Total Assets	\$61,349,241	\$(1,891,721)	\$59,457,520

Liabilities, Surplus and Other Funds

<u>Liabilities:</u>	
Losses (Note 1)	\$22,985,391
Loss adjustment expenses	1,936,508
Commissions payable, contingent commissions and other similar charges	310,436
Other expenses	138,381
Taxes, licenses and fees	627,708
Current federal and foreign income taxes	108,858
Unearned premiums (Note 1)	13,590,549
Advanced premium	25,680
Ceded reinsurance premiums payable	946,388
Funds held under reinsurance treaties	251
Amounts withheld or retained by company for account of others	105,396
Provision for reinsurance (Note 1)	2,444,436
Aggregate write-ins for liabilities	1,963,870
Total Liabilities	\$45,183,852
<u>Surplus and Other Funds:</u>	
Common capital stock	\$1,500,000
Surplus notes	3,000,000
Gross paid in and contributed surplus	5,100,000
Unassigned funds (Note 3)	4,673,669
Surplus as regards policyholders	\$14,273,669
Total liabilities, capital, surplus and other funds	\$59,457,521

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

American Resources Insurance Company
Summary of Operations
For the Periods Ended as Indicated

	6/30/06	12/31/05	12/31/04
Underwriting Income			
Premiums earned (Note 2)	\$10,564,580	\$19,738,595	\$20,447,409
Deductions			
Losses incurred	5,371,037	9,084,000	11,994,604
Loss expenses incurred	1,106,730	2,560,298	2,699,728
Other underwriting expenses incurred	4,616,455	8,324,418	8,060,710
Total underwriting deductions	\$11,094,222	\$19,968,715	\$22,755,042
Net underwriting gain or loss	\$(529,642)	\$(230,120)	\$(2,307,633)
Investment Income			
Net investment income earned	\$699,503	\$1,360,950	\$1,207,581
Net realized capital gains or losses	(15,382)	258,985	83,397
Net Investment gain or loss	\$684,121	\$1,619,934	\$1,290,978
Other Income			
Net gain or loss from agents' or premium balances charged off	\$7,345	\$(31,845)	\$(40,204)
Finance and service charges not included in premiums	38,081	69,209	62,484
Aggregate write-ins for miscellaneous income	(1,909,393)	37,920	44,929
Total other income	\$(1,863,967)	\$75,283	\$67,209
Net income, after dividends to policyholders, after capital gains and before all other federal and foreign income taxes	\$(1,709,488)	\$1,465,097	\$(949,446)
Federal and foreign income taxes incurred	108,652	678,114	(268,771)
Net Income	\$(1,818,140)	\$786,983	\$(680,675)

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

American Resources Insurance Company
Reconciliation of Capital and Surplus
For the period ended as indicated

	6/30/06	12/31/05	12/31/04
Surplus as regards policyholders December 31, prior year	<u>\$17,850,524</u>	<u>\$13,648,099</u>	<u>\$10,990,140</u>
Net income	\$(1,818,140)	\$786,983	\$(680,675)
Change in net unrealized capital gain or loss	59,718	(239,956)	58,999
Change in net deferred income tax	821,219	205,278	32,114
Change in nonadmitted assets	(226,484)	(18,613)	247,083
Change in surplus notes			3,000,000
Change in provision for reinsurance	(2,413,168)	(31,268)	439
Cumulative effects of changes in accounting principles			
Surplus adjustments:			
Paid in		3,600,000	
Dividends to stockholders		(100,000)	
Change in capital and surplus during year	<u>\$(3,576,855)</u>	<u>\$4,202,425</u>	<u>\$2,657,959</u>
Surplus as regards policyholders, end of period	<u>\$14,273,669</u>	<u>\$17,850,524</u>	<u>\$13,648,099</u>

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

NOTES TO FINANCIAL STATEMENTS

Note 1 -	Losses	\$22,985,391
	Unearned Premiums	\$13,590,549
	Provision for Reinsurance	\$ 2,444,436
	Anticipated income from trust accounts (nonadmitted)	\$ 1,147,619

The above captioned amount for Losses is the same as reported by the Company in its June 30, 2006 Quarterly Statement. The above captioned amount for Unearned premiums is \$170,215 more than the \$13,420,334 reported by the Company in its June 30, 2006 Quarterly Statement. The above captioned amount for Provision for reinsurance is \$754,257 more than the \$1,690,179 reported by the Company in its June 30, 2006 Quarterly Statement. The Company did not report Anticipated income from trust accounts (nonadmitted) in its June 30, 2006 Quarterly Statement. The adjustment of \$1,147,619 is \$1,147,619 more than none reported. There were five issues involving the captioned accounts.

These adjustments are interrelated and best understood when broken down by CLIP, as summarized in the following table:

Account	UWC	Warrantech	Marathon	Total
Unearned Premium Reserves	\$0	\$170,215	\$0	\$170,215
Provision for Reinsurance	\$899,325	(\$145,068)	\$0	\$754,257
Anticipated Investment Income	\$834,541	\$284,466	\$28,613	\$1,147,619

Table Notes:

1. Unearned Premium Reserves (UEPR). The Company did not book any UEPR on a net-of-reinsurance basis for the contractual liability insurance policies (CLIP). The UEPR were 100% ceded, and then fully reflected in the provision for reinsurance. The examiners found no evidence of reinsurance for the Warrantech CLIP, as discussed in Issue 1 below. Therefore, the examination estimate of direct UEPR was reflected as a net liability as shown in the table.
2. Provision for Reinsurance. The adjustments to the provision for reinsurance reflect elimination of the Warrantech loss reserves and UEPR, as discussed above. The adjustment also includes examination changes to Ultimate Warranty Corporation (UWC) ceded loss reserves and ceded UEPR.

3. Anticipated Investment Income. The Company did not book an asset for the anticipated investment income on trust funds established for vehicle service contract warranty payments.

The adjustments are further explained within the following Issues 1 through 5:

Issue 1

The Company took a loss reserve credit of \$125,000 and an unearned premium reserve credit of \$20,068 in association with its Warrantech Automotive and Butler Financial contractual liability insurance policies. Management had indicated that these policies were ceded to a reinsurer under a 100% quota share reinsurance contract and accounted for the loss recoverable as such. As of the date of this report, management was not able to provide a signed reinsurance contract or evidence of the reinsurance premium being paid. The Company recorded the transaction as if the reinsurer was unauthorized and did not post collateral. The Company had recorded a liability within its Provision for reinsurance account of \$145,068 for the reserve credits taken.

The examination estimates of direct loss reserves and UEPR applicable to the Warrantech business were \$0 and \$170,215, respectively. These adjustments are discussed in more detail in Issue 4.

The examination net loss reserves are zero because there are not any expected claims against the Warrantech (and Butler) CLIPs. The booked net loss reserves were zero because the Company recognized a 100% ceded reserve credit. Therefore, although there are adjustments to direct loss reserves and the reinsurance treatment of those loss reserves, there is not an indicated adjustment to net loss reserves.

The examination UEPR reflects ARIC's liability for the entire CLIP, whereas the Company recognized only a portion of that liability. This is discussed in Issue 3. The examination adjustments reflect an increase in the direct UEPR as well as a change in the reinsurance accounting of that UEPR. Specifically, the provision for reinsurance was reduced by the Company's estimated UEPR of \$20,068 and the net UEPR was increased by the examination estimate of UEPR of \$170,215.

Issue 2

The reinsurance agreement between the Company and Capital Assurance Risk Retention Group, Inc. states

As regards policies issued by the Company within the scope of this Agreement, the Company agrees that, when it files with the insurance department or sets up on its books reserves for losses (including loss and loss expense paid by the Company but not recovered from the Reinsurer, loss and loss expense reported and outstanding, and an allowance for IBNR as determined by the Company) covered hereunder and/or unearned premium, which it is required by law to set up, it will forward to the Reinsurer a statement showing the proportion of such reserves applicable to them. The Reinsurer hereby agrees that it will fund such reserves by cash advances, trust agreements, escrow accounts or a combination thereof for the benefit of the Company. The Reinsurer will have the option of determining the method of funding referred to above, provided it is acceptable to the Company and the applicable regulatory authorities.

Company management indicated that Capital Assurance Risk Retention Group, Inc. has not posted any collateral even though the Company has recorded loss reserves and unearned premium reserves in relation to the contract. As of the date of this report the Company was unable to provide evidence of any collateral held. The examiners verified that the Company held the full amount of the loss and unearned premium reserve credits taken in relation to the reinsurance agreement within its Provision for reinsurance liability as of June 30, 2006.

The Company has been unsuccessful in its attempts to require Capital Assurance Risk Retention Group to post collateral as provided for by the reinsurance agreement.

Issue 3

The Company's booked direct loss reserves and UEPR for Warrantech were calculated from only a small fraction of the underlying VSCs covered by the CLIP. The Company denied coverage relating to VSCs issued in states where ARIC is not a licensed insurer. The consideration of all VSCs covered by the CLIP was utilized in the determination of the loss and unearned premium reserves for this examination.

The examination UEPR for Warrantech is \$170,215, compared with the Company's booked UEPR of \$20,068. This indicated increase of \$150,147 is

entirely due to including all VSCs covered by the CLIP, rather than the fraction of covered VSCs contemplated by the Company.

The examination estimate of direct loss reserves relating to the Warrantech business is zero, regardless of which states are contemplated. The Company's booked loss reserves (reflected in the provision for reinsurance) were \$125,000.

Issue 4

As noted within "Issue 2" above, the Company recorded loss and unearned premium reserve credits in relation to its Ultimate Warranty Corporation (UWC) CLIP that was reinsured to Capital Assurance Risk Retention Group on a 100% quota share basis. The reinsurer was unauthorized and did not post collateral. The Company held the total of the reserve credits taken within its provision for reinsurance liability. This methodology was deemed appropriate. There were examination adjustments made to the loss reserves and unearned premium reserves in association with the Ultimate Warranty CLIP.

A life insurance actuary prepared the Company's actuarial analysis as of June 30, 2006, and the results were presented in a manner consistent with life insurance accounting. Specifically, the report did not directly address unearned premiums or loss reserves necessary for presentation in a property and casualty financial statement. Rather, the outstanding liability was presented in a manner similar to policy reserves in a life financial statement.

The Company misinterpreted the amount simply presented as "loss" in the actuarial report to represent loss reserves and booked that amount as loss reserves in the June 30, 2006 quarterly statement. That booked loss reserve amount includes elements of unearned premium reserves, losses incurred and unpaid, future incurred losses, as well as investment income on vehicle service contract trust funds. The Company also booked unearned premium reserves (not specifically addressed in the actuarial study).

The Company's consulting actuary utilized anticipated investment income (discussed in Issue 5) from the UWC trust account as an offset to loss reserves for the UWC CLIP. The utilization of anticipated income as an offset to loss reserves was deemed inappropriate. An examination adjustment was made to record the anticipated income as a nonadmitted asset, discussed in Issue 5.

The Company recorded loss reserves of \$1,217,668 in association with its Ultimate Warranty business. The examination indicated that the loss reserves

should have been \$321,183. The Company recorded unearned premium reserves in association with its Ultimate Warranty business of \$327,342. The examination indicated that the unearned premium reserves should have been \$2,123,152. A corresponding adjustment was made to the ceded reserves in recognition of 100% quota share reinsurance. However, the adjustments resulted in an increase of the Provision for reinsurance liability of \$899,325. The recapitulation above includes adjustments for each of these items.

The Ultimate Warranty program accounts for the large majority, \$1.2 million, of the Company's booked direct loss reserves associated with the auto warranty business. The Company's actuary estimated reserves for this program are based on a 125% loss ratio applicable to the underlying vehicle service contracts (VSCs). The Company's CLIPs provide for coverage of underlying VSCs in excess of a 100% loss ratio, or the ratio of VSC warranty payments to trust funds established for those VSC payments.

The Company booked the actuary's \$1,217,668 estimate as direct loss reserves. The Company also booked unearned premium reserves of \$327,342 based on the underlying exposure of VSCs. Although these liabilities are 100% ceded, the Company did not have funds on deposit from the unauthorized reinsurer. Therefore, the entire amount of these ceded loss reserves and unearned premium reserves were reflected as a liability in the provision for reinsurance.

The examination adjustments reflect similar assumptions, but with corrected accounting for each component. The assumed VSC loss ratio of 125% was accepted as reasonable. Therefore, ARIC loss reserves were set equal to 25% (the excess of 100%) of the earned portion of underlying VSC trust funds. That results in direct loss reserves of \$321,183, compared with the booked amount of \$1,217,668. The large reduction is mostly due to the fact that only about 13% of the underlying exposure to losses was "earned" as of June 30, 2006.

The portion of losses that are not yet "earned" was included in the unearned premium reserves. Unearned premium reserves for long-duration contracts are subject to three additional tests for adequacy outlined in SSAP 65. The relevant test in this instance is the present value of losses and expense to be incurred on the unearned premium reserves. For the UWC CLIP, the examination actuary estimated the Company's unearned premium reserves to be \$2,123,252. It is important to note that this reflects investment income on ARIC losses, but not on the underlying VSC trust funds. The examination amount is significantly larger than the Company's booked unearned premium

reserves of \$327,342 because much of the unearned premium reserves was booked by the Company as loss reserves.

The adjustment to the provision for reinsurance relating to UWC is equal to the sum of the adjustments to direct loss reserves and direct unearned premium reserves. Those adjustments were (\$896,485) and \$1,795,910, respectively. Therefore, the UWC portion of the adjustment to the provision for reinsurance is \$899,425.

Issue 5

The Company is entitled to investment income earned on the trust accounts set up to pay underlying VSC claims. These trust accounts are not an asset of the Company. However, according to the administration agreement, the Company is entitled to investment income, regardless of whether or not there is a claim incurred under the CLIP issued by the Company.

The Company's booked loss reserves relating to UWC were reduced for the anticipated investment income. It is not clear whether the booked loss reserves for Warrantech or Marathon reflected anticipated investment income. The examination estimate of anticipated investment income for each block of business was summarized in the table on Page 27. The asset is a non-admitted asset for statutory accounting purposes.

Note 2 - Premiums Earned

\$10,564,580

The above captioned amount is \$170,215 less than the \$10,734,795 reported by the Company in its June 30, 2006 Quarterly Statement. The adjustment is attributable to the adjustment classifying \$170,215 of earned premiums to unearned premiums detailed in Note 1.

The Company recorded premiums in relation to its auto warranty business in which there was no evidence to support the receipt of the premiums. The Company's Secretary and Treasurer, Stephen Pate, indicated that the premiums were paid to the Company's reinsurer, Capital Assurance Risk Retention Group by the Company's insured. The Company could not provide any evidence of the reinsurance agreement, the receipt of premiums, or the payment of reinsurance premiums. Company management indicated that they do not know what happened to the premiums. The premiums recorded as collected but not received amounted to \$20,768. The amount is not material and no additional change was made to the financial statements. The Company recorded ceded

premiums for \$20,768 as well, thereby reducing its net premiums for this segment of business to zero. The Company did not record its premiums received consistent with the Company's reinsurance agreements.

Note 3 – Unassigned funds

\$4,673,669

The above captioned amount is \$924,472 less than the \$5,598,141 reported by the Company in its June 30, 2006 Quarterly Statement. The following is a reconciliation of unassigned funds per this examination:

Unassigned funds per Company		\$5,598,141
Examination decrease/(increase) to liabilities:		
Unearned premiums	\$(170,215)	
Provision for reinsurance	(754,257)	
Change in unassigned funds	\$(924,472)	(924,472)
Total Unassigned funds per examination		<u>\$4,673,669</u>

COMMENTS AND RECOMMENDATIONS

MANAGEMENT AND CONTROL, Conflicts of Interest – page 6

It is recommended that the Company remove its director that is in a position involving a pecuniary interest, require its director to divest his investments creating the pecuniary interest, or cease doing business with the entities that its directors have any ownership interests in order to comply with ALA CODE §27-27-26(a) which states, in part,

Any officer, or director, or any member of any committee or any employee of a domestic insurer who is charged with the duty of investing or handling the insurer's funds... shall not be pecuniarily interested in any loan, pledge or deposit, security, investment, sale, purchase, exchange, reinsurance, or other similar transaction or property of such insurer except as a stockholder or member...

CORPORATE RECORDS – Page 7

It is recommended that the Company maintain complete records of its transactions and affairs at its home office in accordance with ALA CODE §27-27-29(a) which states, "Every domestic insurer shall have, and maintain, its principal place of business and home office in this state and shall keep therein,

complete records of its assets, transactions and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted."

REINSURANCE – Page 12

It is recommended that the Company collect the premiums due the Company under the Marathon contractual liability insurance policy and take control of the remittances due the Company's reinsurer in accordance with the Company's reinsurance agreement with Marathon Financial Insurance Company, Inc. which states, "Within 20 days after the close of each month, the Company will furnish the Reinsurer with a report summarizing the gross premium, premium ceded less return premium and commission, losses paid, loss expense paid, monies recovered, and net balance due each party. The net balance will be paid within 25 days after the close of the respective month."

It is recommended that the Company subject all of its reinsurance contracts to a minimum standards review.

It is recommended that the Company perform an evaluation of the financial strength of assuming entities and make certain that the reinsuring entities meet minimum acceptability standards.

It is recommended that the Company amend its reinsurance agreement with Marathon Financial Insurance Company, Inc. to identify the effective date of coverage and the date in which the agreement may be cancelled.

ACCOUNTS AND RECORDS – Page 14

It is recommended that the Company maintain records of the vehicle service contracts that are covered under its auto warranty contractual liability insurance policies in accordance with ALA CODE §27-27-29(a)(1975) which states, in part, "Every domestic insurer shall have, and maintain... complete records of its assets, transactions and affairs."

It is recommended that the Company perform audits of the vehicle service warranty contract providers' records as allowed by the contractual liability insurance policies to ascertain that the records provided to the Company are correct.

It is recommended that the Company not make advances to its controlling stockholders in accordance with ALA CODE §27-41-36(a) which states, "After January 1, 1978, an insurer shall not invest nor lend its funds upon the security of any note or other evidence of indebtedness of any director, officer or controlling stockholder of the insurer, except as to policy loans authorized under §27-41-25 and except as provided in §27-1-2, §27-27-26 and §27-37-2 of the Alabama Insurance Code."

It is recommended that the Company maintain accurate records of its transactions in accordance with ALA. CODE §27-27-29 (a) (1975) which states, in part, "Every domestic insurer... shall keep therein complete records of its assets, transactions and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted."

NOTES TO FINANCIAL STATEMENTS , Note 1 – Page 27

It is recommended that the Company only record reserve credits for accounts that are supported by a signed reinsurance agreement and evidence of the payment by the Company of the reinsurer's pro rata share of the premiums.

It is recommended that the Company continue its efforts to require its reinsurer, Capital Assurance Risk Retention Group, Inc. to post collateral for the loss, loss adjustment expense, and unearned premium reserves recorded by the Company in relation to the business ceded to the reinsurer as required to by the reinsurance agreement with the Company which states,

As regards policies issued by the Company within the scope of this Agreement, the Company agrees that, when it files with the insurance department or sets up on its books reserves for losses (including loss and loss expense paid by the Company but not recovered from the Reinsurer, loss and loss expense reported and outstanding, and an allowance for IBNR as determined by the Company) covered hereunder and/or unearned premium, which it is required by law to set up, it will forward to the Reinsurer a statement showing the proportion of such reserves applicable to them. The Reinsurer hereby agrees that it will fund such reserves by cash advances, trust agreements, escrow accounts or a combination thereof for the benefit of the Company. The Reinsurer will have the option of determining the method of funding referred to above, provided it is acceptable to the Company and the applicable regulatory authorities.

It is recommended that the Company record loss and unearned premium reserves with consideration given to all of the vehicle service contracts covered by the Warrantech contractual liability insurance policy except in those cases in which the Company has successfully denied coverage.

It is recommended that the Company correctly account for their unpaid claims liabilities in accordance with SSAP 55 which states,

The following are types of future costs relating to property and casualty contracts, as defined in SSAP No. 50, which shall be considered in determining liabilities for unpaid losses and loss adjustment expenses: a. Reported losses: Expected payments for losses relating to insured events that have occurred and have been reported to, but not paid by, the reporting entity as of the statement date; b. Incurred But Not Reported Losses (IBNR): Expected payments for losses relating to insured events that have occurred but have not been reported to the reporting entity as of the statement date... c. Loss adjustment expenses...

NOTES TO FINANCIAL STATEMENTS, Note 2 – Page 32

It is recommended that the Company record the receipt of premiums and the remittance of reinsurance premiums consistent with the terms of the related contracts and agreements.

CONTINGENT LIABILITIES AND PENDING LITIGATION

The Company disclosed in its June 30, 2006 Notes to Financial Statements that there were 3,196 automobile service warranty contracts submitted for coverage but denied by the Company because the service warranty contracts were written prior to the inception date of the contractual liability insurance policy covering the said contracts or the vehicle service contracts were written in states in which the Company was not licensed. Further discussion of the disputed 3,196 contracts is included in this report under the captions “EXAMINATION FINDINGS – Determine the Company’s liabilities with Respect to the Company’s Automobile Warranty Business” and NOTES TO FINANCIAL STATEMENTS – Note 1.”

Some of the trust account assets were allegedly misappropriated. The trust agreements indicate that if the ultimate vehicle service contract (VSC) claims are less than the aggregate of funds collected associated with the respective

contractual liability insurance policy, the administrator is entitled to keep the amount of the initial trust funds in excess of the aggregate VSC claim payments. If the Company is held responsible for the alleged misappropriated trust funds, there will be a contingent liability for the Company to return the misappropriated funds to the administrator. The trust funds are not assets of the Company and are not reflected in its balance sheet. The trust funds do not offset any potential Company unpaid claim liabilities. However, the trust assets are given consideration in determining the amount of any CLIP claim against the Company. The Company recorded a liability for "Contingent liability" associated with the contingency during the second quarter of 2006. The reported "Contingent liability" was \$1,934,304 as of June 30, 2006. Further discussion of the alleged misappropriated funds is included in this report under the caption "EXAMINATION FINDINGS - Determine if all of the funds that are required to be deposited or invested in the automobile warranty trust accounts have been properly deposited or invested; If the assets were misappropriated, determine how so, and determine the whereabouts of the misappropriated assets if possible; Identify potential fraudulent activities that may have occurred."

The Company has taken a position in which it alleges that former directors, James Tait and Lee Summers may have committed fraudulent acts against the Company. The Company has filed a civil action against the two former directors alleging fraud.

SUBSEQUENT EVENTS

A review of the events and transactions subsequent to June 30, 2006 was performed. The information obtained was utilized in developing the examination findings included in this report. When reviewing the detail supporting the pending acquisition of the Ohio insurance company named American Hardware Mutual Insurance (AHMI), it was noted that the Company was involved in the issuance of a \$100,000 wire transfer to the account of AHMI at National City Bank in Ohio. Per management, the purpose of this wire transfer was to serve as earnest money towards the purchase of American Hardware Mutual Insurance. Lee Summers, a former director of the Company requested this wire to be effected. The time ran out on the option period and the Company lost its \$100,000 deposit.

Subsequent to reviewing a draft copy of this report, Company management represented that the stock certificates of ARIC Investments, Inc. were issued to the four individuals and entities that Company management had indicated to

have converted their convertible preferred shares into voting common shares by way of a deemed conversion. The examiners were notified of the issuance of the stock certificates at the exit conference held on November 16, 2006. Copies of the stock certificates issued were provided to the examiners on November 16, 2006. The certificates bore the date of October 25, 2006. On November 17, 2006, the examiners were provided replacement certificates issued to the same entities and individuals for the same number of shares. The replacement certificates bore the date of November 17, 2006. The certificates issued agreed to the percentages of ownership reported for the respective individuals/entities in the Company's June 30, 2006 Quarterly Statement. HAIG, LP, the sole owner of AR Holding, Inc., may be unaware that conversion and other rights have been exercised by stakeholders of ARIC Investment which have the effect of diluting HAIG LP's indirect ownership of the Company.

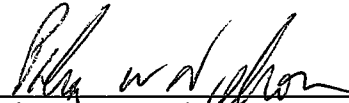
CONCLUSION

Acknowledgement is hereby made of the courtesy and cooperation extended by all persons representing American Resources Insurance Company during this examination.

Insurance examination procedures, as recommended by the National Association of Insurance Commissioners, have been followed in connection with the verification and valuation of assets and the determination of liabilities set forth in this report of limited scope examination.

In addition to the undersigned, Thomas W. Salo, examiner; and Glenn Taylor, FCAS, MAAA and Randall Ross, FCAS, MAAA, of Taylor-Walker & Associates, Consulting Actuaries; all representing the Alabama Department of Insurance, participated in the examination of American Resources Insurance Company.

Respectfully submitted,



Palmer W. Nelson, CFE

Examiner-in-charge

Alabama Department of Insurance

Southeastern Zone, NAIC